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ECONOMISTS TELL TREASURY DAS DOHNER

¶1. (U) Summary: Hong Kong-based China analysts warned U.S. Treasury representatives that unproductive investment was a disturbing trend that threatened to derail Chinese economic growth and stability, but that the risk to the Chinese economy from a U.S. slowdown was minimal. Analysts differed in their assessment of Chinese inflation, with some dismissing current price increases as a one-off food supply shock and others seeing long-term wage and price increases as a potential threat to growth. Renminbi appreciation thus far has had no discernible effect on U.S./China trade flows and, barring a significant U.S. economic slowdown, analysts expect even a large appreciation would simply shift U.S. demand for imports to other suppliers. A sharp drop in Chinese exports is unlikely to hurt the Chinese economy and could even benefit China by encouraging the development of domestic consumption, but could harm regional suppliers tied to Chinese export-processing industries. End Summary.

¶2. (U) Treasury Deputy Assistant Secretary for East Asia, Robert Dohner, accompanied by Treasury East Asia Office Director Mathew Harsaager, and Treasury economists T.T. Yang and Ben Cushman, met with Hong Kong-based economists and analysts September 24-5 to discuss Chinese macroeconomic performance, currency policy and risks to the Chinese economy. Dohner's party met separately with Michael Spencer, Chief Economist, Asia and Jun Ma, Chief Economist, Greater China at Deutsche Bank; Robert McCauley, Chief Representative at the Bank for International Settlements (BIS); Yiping Huang, Managing Director at Citigroup; and Morgan Stanley's Managing Director and Chief Economist, Stephen Roach.

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Inflation is not a threat... or is it?
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¶3. (SBU) Views about the seriousness of inflationary pressures in China were mixed. Some, including Stephen Roach of Morgan Stanley and Jun Ma and Michael Spencer of Deutsche Bank, dismissed rising Chinese inflation as a food-based supply shock that would correct itself. While acknowledging that increasing food prices threaten those at the lower end of the income scale and are a short-term risk to stability, they believe prospects for the fall harvest are good and expected the price of pork to fall dramatically by next year. Ma and Spencer predicted that inflation would fall from current levels of over 6% to just 3% by early 2008. In the near term, they suggested the Chinese authorities would use price controls and other mechanisms to force manufacturers to keep prices down.

¶4. (SBU) Others, including Citigroup's Huang Yiping and BIS's Robert McCauley, told DAS Dohner that one-off supply shocks were part of the problem, but they were less sanguine about the prospects for Chinese prices. Huang noted that prices have been steadily trending up for some time and would continue to do so, barring agricultural trade liberalization. McCauley added that, with over 45% of the Chinese CPI measurement comprised of "core" elements like food, official inflation statistics did not do a good job of capturing price movements. With current inflation in China pushing interest rates into negative territory, Chinese are increasingly moving money out of traditional savings and into goods, property and stocks, said Huang, feeding bubbles in land and equity prices.

¶5. (U) Analysts acknowledged reports that labor was becoming scarce in the manufacturing centers of the Pearl River Delta and Shanghai, and that formal wages in these areas are increasing, but agreed that rising wages are more than offset by increases in productivity. Labor costs should not drive inflation in the near term, they said.

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China Immune from U.S. Recession?
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¶6. (SBU) Analysts agreed that the subprime loan-generated liquidity crunch did not appear to be a problem for Asian banks. Of greater concern is that a U.S. economic slowdown could hurt Asian exports and slow growth in Asia outside of China. Ma and Spencer worried that a U.S. recession or protectionist trade legislation directed at China could have disastrous effects on Asian economies. The current trade paradigm has regional economies increasingly exporting raw



materials and intermediate components to China for processing and eventual export. Spencer argued that a sharp slowdown of Chinese exports to the U.S. would catch other regional producers, reducing their exports, and undercutting confidence in the "still fragile" economic growth in the region. The Deutsche Bank economists warned that falling Chinese exports could lead to competitive devaluations in Southeast Asia, slowing investment and further eroding industrial capacity, potentially fostering another regional economic crisis. A U.S. recession might even benefit China by reducing the red-hot growth rate to just 10% and encouraging the development of domestic consumption, said Ma.

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Too Much Investment Choking the Chinese Economy
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¶7. (SBU) Domestic consumption is the key to continued Chinese economic development, according to Morgan Stanley's Stephen Roach. Total consumption accounts for only 50% of China's economic activity and just 35% is private sector consumption. China needs pro-consumption policies and accelerated capital reforms to create sustainable growth. The current Chinese leadership is more risk-averse than their predecessors, said Roach, and less willing to embrace bold measures. Re-orienting the economy and controlling investment rates are crucial to keeping China on a sustainable growth path, but incentives at the provincial level still reward rapid growth over sustainability. Barring a large increase in interest rates, the central government's only near-term option for controlling investment growth is administrative controls, including strict management by the National Development and Reform Commission (NDRC), said Roach.

¶8. (SBU) Huang agreed that economically inefficient investment is becoming a problem for China. Subsidized land, artificially low labor costs, administered energy prices, and lax environmental regulatory enforcement reduce the cost of investment and encourage projects that would be rejected if

the true costs were born by investors. Ma and Spencer agreed that most Chinese investment is still directed toward infrastructure, heavy industry, and real estate. The Deutsche Bank economists predicted real estate investment would grow by more than 20% per year over the next several years. Roach noted concerns about a property bubble, but argued that the Chinese leadership views this as a natural result of shifting investment patterns.

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RMB Appreciation Won't Solve U.S. Trade Deficit
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¶9. (SBU) Dohner asked analysts whether RMB appreciation would significantly affect the U.S. current account deficit. Roach responded that RMB strengthening over the past three years had done nothing to reduce Chinese export growth and suggested that a large and sudden appreciation of at least 15% is the only way to impact Chinese exports to the U.S. He predicted that such a shock would have repercussions in the Chinese domestic financial sector, noting that many banks have indirect exposure to U.S. dollars; mid-size banks in particular are unsophisticated managers of currency risk, he said. Morgan Stanley believes the U.S. savings rate is the key to addressing the current account deficit. Even if the RMB appreciated dramatically, Roach predicted, the U.S. appetite for imports would just shift elsewhere.

¶10. (U) Treasury Deputy Assistant Secretary Dohner did not have the opportunity to clear this message.
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